
Volume 116
Issue 3 *Dickinson Law Review* - Volume 116,
2011-2012

1-1-2012

Asset Acquisitions: Assuming and Avoiding Liabilities

Byron F. Egan

Follow this and additional works at: <https://ideas.dickinsonlaw.psu.edu/dlra>

Recommended Citation

Byron F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 DICK. L. REV. 913 (2012).
Available at: <https://ideas.dickinsonlaw.psu.edu/dlra/vol116/iss3/8>

This Article is brought to you for free and open access by the Law Reviews at Dickinson Law IDEAS. It has been accepted for inclusion in Dickinson Law Review by an authorized editor of Dickinson Law IDEAS. For more information, please contact lja10@psu.edu.

Asset Acquisitions: Assuming and Avoiding Liabilities

Byron F. Egan*

Table of Contents

I.	INTRODUCTION	914
II.	WHETHER TO DO AN ASSET PURCHASE	917
	A. Purchased Assets.....	917
	B. Contractual Rights	918
	C. Intellectual Property Rights.....	919
	D. Governmental Authorizations	920
	E. Assumed Liabilities.....	920
	F. Dissent and Appraisal Rights	923
	1. Delaware Law	924
	2. Texas Law	925
	G. Income Taxes	926
	H. Transfer Taxes	929
	I. Employment Issues	930
	J. Confidentiality Agreement.....	930
	K. Exclusivity Agreement.....	930
	L. Letter of Intent	931
III.	SUCCESSOR LIABILITY	931
	A. Background.....	931
	B. The General Rule of Successor Liability	933
	1. Express or Implied Assumption	935
	2. De Facto Merger	935

* Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas. Mr. Egan is a member of the ABA Business Law Section's Mergers & Acquisitions Committee, serves as Senior Vice Chair of the Committee and Chair of its Executive Council and served as Co-Chair of its Asset Acquisition Agreement Task Force which prepared the ABA Model Asset Purchase Agreement with Commentary.

Mr. Egan wishes to acknowledge contributions of the following in preparing this paper: Richard De Rose of Houlihan Lokey Howard & Zukin in New York, NY; Robert T. Harper of Buchanan Ingersoll & Rooney PC in Pittsburgh, PA; Frances Murphy of Slaughter and May in London, UK; Michael L. Schler of Cravath, Swaine & Moore LLP in New York, NY; H. Lawrence Tafe III of Day Pitney LLP in Boston, MA; Prof. Samuel C. Thompson, Jr. of The Dickinson School of Law of the Pennsylvania State University in University Park, PA; Donald J. Wolfe Jr. of Potter Anderson & Corroon LLP in Wilmington, DE; and Kristina M. Campbell, Michael L. Laussade, Robert P. Hyndman, and Peter K. Wahl of Jackson Walker L.L.P. in Dallas, TX.

3. Mere Continuation	939
4. Fraud	939
5. Continuity of Enterprise.....	940
6. Product-Line Exception	940
7. Duty to Warn.....	943
8. Inadequate Consideration/Creditors Not Provided For	943
9. Liability Imposed By Statute or Superseding Law	944
a. Environmental Statutes.....	945
b. Federal Common Law/ERISA.....	947
c. Effect of Bankruptcy Court Orders.....	948
C. Some Suggested Responses	950
1. Analysis of Transaction	950
a. Product Liability.....	950
b. Environmental Cases	951
c. Applicable Laws.....	953
2. Structure of Transaction.....	953
3. Asset Purchase Agreement Provisions.....	954
a. Liabilities Excluded.....	954
b. Indemnification.....	954
4. Selling Corporation—Survival.....	954
5. Limitation on Assets	955

I. INTRODUCTION

Buying or selling a closely held business, including the purchase of a division or a subsidiary, can be structured as (i) a statutory combination such as a statutory merger or share exchange, (ii) a negotiated purchase of outstanding stock from existing shareholders, or (iii) a purchase of assets from the business. The transaction typically revolves around an agreement between the buyer and the selling entity, and sometimes its owners, setting forth the terms of the deal.

Purchases of assets are characterized by the acquisition by the buyer of specified assets from an entity, which may or may not represent all or substantially all of its assets, and the assumption by the buyer of specified liabilities of the seller, which typically do not represent all of the liabilities of the seller. When the parties choose to structure an acquisition as an asset purchase, there are unique drafting and negotiating issues regarding the specification of which assets and liabilities are transferred to the buyer, as well as the representations, closing conditions, indemnification, and other provisions essential to memorializing the bargain reached by the parties. There are also statutory (e.g., bulk sales and fraudulent transfer statutes) and common law issues (e.g., de facto merger and other successor liability theories) unique to asset purchase transactions that could result in an asset

purchaser being held liable for liabilities of the seller which it did not agree to assume.

These drafting and legal issues are dealt with from a United States (U.S.) law perspective in (1) the *Model Asset Purchase Agreement with Commentary*, which was published by the Mergers & Acquisitions Committee (formerly named the Negotiated Acquisitions Committee) (M&A Committee) of the American Bar Association (ABA) in 2001 (Model Asset Purchase Agreement, or Model Agreement); (2) the *Revised Model Stock Purchase Agreement with Commentary*, which was published by the M&A Committee in 2010 (Model Stock Purchase Agreement, or RMSPA); and (3) the *Model Merger Agreement for the Acquisition of a Public Company*, which was published by the M&A Committee in 2011 (Model Public Company Merger Agreement). In recognition of how mergers and acquisitions (M&A) have become increasingly global, the Model Asset Purchase Agreement was accompanied by a separate M&A Committee volume in 2001 entitled *International Asset Acquisitions*, which included summaries of the laws of 33 other countries relevant to asset acquisitions, and in 2007 was followed by another M&A Committee book, which was entitled *International Mergers and Acquisitions Due Diligence* and surveyed relevant laws from 39 countries.

A number of things can happen during the period between the signing of a purchase agreement and the closing of the transaction that can cause a buyer to have second thoughts about the transaction. For example, the buyer might discover material misstatements or omissions in the seller's representations and warranties, or events might occur, such as the filing of litigation or an assessment of taxes, that could result in a material liability or, at the very least, additional costs that had not been anticipated. There may also be developments that could seriously affect the future prospects of the business to be purchased, such as a significant downturn in its revenues or earnings or the adoption of governmental regulations that could adversely impact the entire industry in which the target operates.

The buyer initially will need to assess the potential impact of any such misstatement, omission, or event. If a potential problem can be quantified, the analysis will be somewhat easier. However, the impact in many situations will not be susceptible to quantification, making it difficult to determine materiality and to assess the extent of the buyer's exposure. Whatever the source of the matter, the buyer may want to terminate the acquisition agreement or, alternatively, to close the transaction and seek recovery from the seller. If the buyer wants to terminate the agreement, how strong is its legal position and how great is the risk that the seller will dispute termination and commence a

proceeding to seek damages or compel the buyer to proceed with the acquisition? If the buyer wants to close, could it be held responsible for the problem and, if so, what is the likelihood of recovering any resulting damage or loss against the seller? Will closing the transaction with knowledge of the misstatement, omission, or event have any bearing on the likelihood of recovering?

The dilemma facing a buyer under these circumstances seems to be occurring more often in recent years. This is highlighted by the Delaware Chancery Court decisions in *IBP, Inc. v. Tyson Foods, Inc.*,¹ in which the court ruled that the buyer did not have a valid basis to terminate the merger agreement and ordered that the merger be consummated, and *Frontier Oil Corp. v. Holly Corp.*,² in which the court ruled a target had not repudiated a merger agreement by seeking to restructure the transaction due to legal proceedings commenced against the buyer after the merger agreement was signed. While these cases are each somewhat unique and involved mergers of publicly-held corporations, the same considerations will generally apply to acquisitions of closely-held businesses.³ In the event that a buyer wrongfully terminates the purchase agreement or refuses to close, the buyer could be liable for damages under common law for breach of contract.⁴

The issues to be dealt with by the parties to an asset transfer will depend somewhat on the structure of the transaction and the wording of the acquisition agreement. Regardless of the wording of the agreement, however, there are some situations in which a buyer can become responsible for a seller's liabilities under successor liability doctrines. The analysis of these issues is somewhat more complicated in the acquisition of assets, whether it be the acquisition of a division or the purchase of all the assets of a seller.

1. *IBP, Inc. v. Tyson Foods Inc. (In re IBP, Inc. S'holders Litig.)*, 789 A.2d 14 (Del. Ch. 2001).

2. *Frontier Oil Corp. v. Holly Corp.*, No. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

3. *Nixon v. Blackwell*, 626 A.2d 1366, 1380-81 (Del. 1993) (en banc) (refusing to create special fiduciary duty rules applicable in closely held corporations); see *Merner v. Merner*, 129 F. App'x 342, 343 (9th Cir. 2005) (California would follow the approach of Delaware in declining to make special fiduciary duty rules for closely held corporations). *But see* *Donahue v. Rodd Electrotyp Co.*, 328 N.E.2d 505, 515, 593 n.17 (Mass. 1975) (comparing a close corporation to a partnership and holding that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another").

4. See *Rus, Inc. v. Bay Indus.*, No. 01 Civ.6133(GEL), 2004 WL 1240578 (S.D.N.Y. May 25, 2004); see also MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY § 11.4 cmt. (2001).

II. WHETHER TO DO AN ASSET PURCHASE

An acquisition might be structured as an asset purchase for a variety of reasons. It may be the only structure that can be used when a noncorporate seller is involved or where the buyer is only interested in purchasing a portion of the company's assets or assuming only certain of its liabilities. If the stock of a company is widely held or it is likely that one or more of the shareholders will not consent, a sale of stock (except perhaps by way of a statutory merger or share exchange) may be impractical. In many cases, however, an acquisition can be structured as a merger, a purchase of stock or a purchase of assets.

As a general rule, often it will be in the buyer's best interests to purchase assets but in the seller's best interests to sell stock or merge. Because of these competing interests, it is important that counsel for both parties be involved at the outset in weighing the various legal and business considerations in an effort to arrive at the optimum, or at least an acceptable, structure. Some of the considerations are specific to the business in which a company engages, some relate to the particular corporate or other structure of the buyer and the seller, and others are more general in nature.

Set forth below are some of the more typical matters to be addressed in evaluating an asset purchase as an alternative to a stock purchase or a merger or a share exchange (statutory combination).

A. *Purchased Assets*

Asset transactions are typically more complicated and more time consuming than stock purchases and statutory combinations. In contrast to a stock purchase, the buyer in an asset transaction will only acquire the assets described in the acquisition agreement. Accordingly, the assets to be purchased are often described with specificity in the agreement and the transfer documents. The usual practice, however, is for buyer's counsel to use a broad description that includes all of the seller's assets, while describing the more important categories, and then to specifically describe the assets to be excluded and retained by the seller. Often excluded are cash, accounts receivable, litigation claims or claims for tax refunds, personal assets, and certain records pertaining only to the seller's organization. This puts the burden on the seller to specifically identify the assets that are to be retained.

A purchase of assets also is cumbersome because transfer of the seller's assets to the buyer must be documented and separate filings or recordings may be necessary to effect the transfer. This often will involve separate real property deeds, lease assignments, patent and trademark assignments, motor vehicle registrations, and other evidences

of transfer that cannot simply be covered by a general bill of sale or assignment. Moreover, these transfers may involve assets in a number of jurisdictions, all with different forms and other requirements for filing and recording.

Some of the difficulties of an asset sale can be avoided if the seller first transfers all the assets to be sold to a newly formed, wholly owned limited liability company (LLC) of which the seller is the sole member. The LLC could also assume any liabilities intended to be transferred to the buyer. These transfers, and any requisite documentation, could be made well in advance of the closing of the sale with the buyer. Then, on the closing date, the only transaction would be a simple transfer of all the LLC interests to the buyer. The transfers of assets to the LLC could even be made before the purchase agreement is signed, allowing the purchase agreement to simply refer to a sale of the LLC interests rather than identifying each asset to be transferred to the buyer. From a federal income tax point of view, the wholly owned LLC can be classified as a "disregarded entity," with all of its assets treated as being owned directly by the seller.⁵ The sale of the LLC interests is therefore treated as a sale of the underlying assets, so the seller is taxed as if it had sold assets, and the buyer is treated as buying the assets. This approach has all the tax advantages and disadvantages of an asset sale (as opposed to a stock sale) for federal income tax purposes. This structure could, however, have different results for state and local taxes other than income taxes (such as property transfer taxes).

B. Contractual Rights

Among the assets to be transferred will be the seller's rights under contracts pertaining to its business. Often these contractual rights cannot be assigned without the consent of other parties. The most common examples are leases that require consent of the lessor and joint ventures or strategic alliances that require consent of the joint venturer or partner. This can be an opportunity for the third party to request confidential information regarding the financial or operational capability of the buyer and to extract concessions in return for granting its consent. This might be avoided by a purchase of stock or a statutory combination.⁶ Leases

5. See Michael L. Schler, *Basic Tax Issues in Acquisition Transactions*, 116 PENN ST. L. REV. 879, 894 (discussing dropdown of assets to LLC and sale of LLC interests).

6. See *Branmar Theatre Co. v. Branmar, Inc.*, 264 A.2d 526, 528 (Del. Ch. 1970) (holding that a sale of a company's stock is not an "assignment" of a lease of the company where the lease did not expressly provide for forfeiture in the event the stockholders sold their shares); *Baxter Pharm. Prods., Inc. v. ESI Lederle Inc.*, No. 16863, 1999 WL 160148, at *5 (Del. Ch. Mar. 11, 1999) (holding that nonassignability clause that does not prohibit, directly or by implication, a stock acquisition or change of

and other agreements often require consent of other parties to any change in ownership or control, whatever the structure of the acquisition. Many government contracts cannot be assigned and require a novation with the buyer after the transaction is consummated. This can pose a significant risk to a buyer.

Asset purchases also present difficult questions about ongoing coverage for risks insured against by the seller. Most insurance policies are, by their terms, not assignable and a buyer may not be able to secure coverage for acts involving the seller or products it manufactures or services it renders prior to the closing.⁷

C. Intellectual Property Rights

Under federal law, intellectual property rights are not assignable, even indirectly as part of a business combination transaction, unless the owner has agreed otherwise.⁸ A buyer's due diligence review often takes

ownership is not triggered by a stock purchase); *Star Cellular Tel. Co., Inc. v. Baton Rouge CGSA, Inc.*, No. 12507, 19 Del. J. Corp. L. 875, 893 (Del. Ch. Aug. 2, 1993), *aff'd*, 647 A.2d 382 (Del. 1994) (declining to attribute to contracting parties an intent to prohibit a merger where a partnership agreement did not expressly include transfers by operation of law in its anti-transfer provision and noting that drafter could have drafted clause to apply to all transfers, including by operation of law); *see generally* Philip M. Haines, *The Efficient Merger: When and Why Courts Interpret Business Transactions to Trigger Anti-Assignment and Anti-Transfer Provisions*, 61 BAYLOR L. REV. 683 (2009). However, some courts have held that a merger violates a nonassignment clause. *See, e.g.*, *PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090, 1095-96 (6th Cir. 1979); *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, No. 5589-VCP, 2011 WL 1348438, at *12-13 (Del. Ch. Apr. 8, 2011) (Delaware Chancery Court declined to dismiss a claim that a reverse triangular merger affected an assignment of rights under a contract which required consent for assignments "by operation of law or otherwise," but noted that it might reach the conclusion on summary judgment or after trial and that whether a reverse triangular merger effects an assignment by operation of law requiring contractual consent is an area unsettled under Delaware law). At least one court held that such a violation occurred in a merger where the survivor was the contracting party. *See SQL Solutions, Inc. v. Oracle Corp.*, No. C-91-1079 MHP, 1991 WL 626458, at *4 (N.D. Cal. Dec. 18, 1991).

7. *See, for example, Henkel Corp. v. Hartford Accident & Indemnification Co.*, 62 P.3d 69, 73 (Cal. 2003), in which the California Supreme Court held that, where a successor's liability for injuries arose by contract rather than by operation of law, the successor was not entitled to coverage under a predecessor's insurance policies because the insurance company had not consented to the assignment of the policies. For an analysis of the *Henkel* decision and a discussion of decisions in other jurisdictions, see Henry Lesser, Mike Tracy & Nathaniel McKitterick, *M&A Acquirors Beware: When You Succeed to the Liabilities of a Transferor, Don't Assume (at Least, in California) that the Existing Insurance Transfers Too*, DEAL POINTS (ABA Bus. L. Sec. Comm. on Negotiated Acquisitions, Chic., Ill.), Fall 2003, at 2, available at http://apps.americanbar.org/buslaw/newsletter/0018/materials/08_03.pdf.

8. In *Cincom Sys., Inc. v. Novelis Corp.*, 581 F.3d 431 (6th Cir. 2009), an internal forward merger between sibling entities was held to constitute an impermissible software license transfer, notwithstanding a state corporation statute that provides that a merger

into consideration not only the language of the license agreements, but also the federal law presumption against assignability of patent or copyright licenses.

D. Governmental Authorizations

Transfer of licenses, permits, or other authorizations granted to a seller by governmental or quasi-governmental entities may be required. In some cases, an application for a transfer or, if the authorization is not transferable, for a new authorization, may involve hearings or other administrative delays in addition to the risk of losing the authorization. Many businesses may have been “grandfathered” under regulatory schemes, and are thereby exempted from any need to make costly improvements to their properties; the buyer may lose the “grandfather” benefits and be subject to additional compliance costs.

E. Assumed Liabilities

An important reason for structuring an acquisition as an asset transaction is the desire on the part of a buyer to limit its responsibility for liabilities of the seller, particularly unknown or contingent liabilities.

Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to

vests title to assets in the surviving corporation without any transfer having occurred. The *Cincom* case involved Cincom’s non-exclusive license of software to a wholly owned subsidiary of Alcan, Inc. The license agreement required licensee to obtain Cincom’s written approval prior to any transfer of its rights or obligations under the agreement. As part of an internal corporate restructuring, the subsidiary of Alcan eventually forward merged into another subsidiary of Alcan, causing the software to be owned by a different entity, but the software remained on the same computer specified by the license agreement and the use of the software by the surviving entity was unchanged. The Sixth Circuit found that the merger was a transfer in breach of the express terms of Cincom’s license and held that software licenses did not vest with the surviving entity formed as part of a corporate restructuring, notwithstanding Ohio’s merger law that automatically vests assets with the surviving entity. Relying instead on federal common law, the Sixth Circuit aligned itself with the presumption that, in the context of intellectual property, a license is non-transferable unless there is an express provision to the contrary. The reasoning in *Cincom* follows that of *PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090 (6th Cir. 1979), *cert. denied*, 444 U.S. 930 (1979), which held that, although state law provides for the automatic transfer and vesting of licenses in the successor corporation in a merger without any transfer having occurred, an intellectual property license, based on applicable federal law, is presumed to be non-assignable and nontransferable in the absence of express provisions to the contrary in the license; held the state merger statute was preempted and trumped by this federal law presumption of non-transferability. See H. Justin Pace, *Anti-Assignment Provisions, Copyright Licenses, and Intra-Group Mergers: The Effect of Cincom v. Novelis*, 9 NW. J. TECH. & INTELL. PROP. 263 (2010).

determine which liabilities of the seller it will contractually assume. Accordingly, one of the most important issues to be resolved is what liabilities incurred by the seller prior to the closing are to be assumed by the buyer. It is rare in an asset purchase for the buyer not to assume some of the seller's liabilities relating to the business, as for example the seller's obligations under contracts for the performance of services or the manufacture and delivery of goods after the closing. Most of the seller's liabilities will be set forth in the representations and warranties of the seller in the acquisition agreement and in the seller's disclosure letter or schedules, reflected in the seller's financial statements or otherwise disclosed by the seller in the course of the negotiations and due diligence. For these known liabilities, the issue as to which will be assumed by the buyer and which will stay with the seller is reflected in the express terms of the acquisition agreement.

For unknown liabilities or liabilities that are imposed on the buyer as a matter of law, the solution is not so easy and lawyers spend significant time and effort dealing with the allocation of responsibility and risk in respect of such liabilities. Many acquisition agreements provide that none of the liabilities of the seller, other than those specifically identified, are being assumed by the buyer and then give examples of the types of liabilities not being assumed (e.g., tax, products, and environmental liabilities). There are, however, some recognized exceptions to a buyer's ability to avoid the seller's liabilities by the terms of the acquisition agreement, including the following:

- Bulk sales laws permit creditors of a seller to follow the assets of certain types of sellers into the hands of a buyer unless specified procedures are followed.
- Under fraudulent conveyance or transfer statutes, the assets acquired by the buyer can be reached by creditors of the seller under certain circumstances. Actual fraud is not required and a statute may apply merely where the purchase price is not deemed fair consideration for the transfer of assets and the seller is, or is rendered, insolvent.
- Liabilities can be assumed by implication, which may be the result of imprecise drafting or third-party beneficiary arguments that can leave a buyer with responsibility for liabilities of the seller.
- Some state tax statutes provide that taxing authorities can follow the assets to recover taxes owed by the seller; often the

buyer can secure a waiver from the state or other accommodation to eliminate this risk.

- Environmental liability can be imposed by laws that can hold a current owner of property jointly and severally liable for contamination at the property, regardless of when it occurred. While liability can be contractually allocated, it is not a defense to government claims. Thus, an asset purchaser may still be subject to environmental claims, even if the seller is ultimately paying for it. This issue become more problematic if an indemnitor is no longer able to indemnify an asset purchaser.
- In some states, courts have held buyers of manufacturing businesses responsible for tort liabilities for defects in products manufactured by a seller while it controlled the business. Similarly, some courts hold that certain environmental liabilities pass to the buyer that acquires substantially all the seller's assets, carries on the business and benefits from the continuation.
- The purchaser of a business may have successor liability for the seller's unfair labor practices, employment discrimination, pension obligations or other liabilities to employees.
- In certain jurisdictions, the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a "de facto merger," which would result in the buyer being held to have assumed all of the seller's liabilities.⁹

None of these exceptions prevents a buyer from attempting to limit the liabilities to be assumed. Thus, either by compliance with a statutory scheme (e.g., the bulk sales laws or state tax lien waiver procedure) or by careful drafting, a conscientious buyer can take comfort in the fact that most contractual provisions of the acquisition agreement should be respected by the courts and should protect the buyer against unforeseen liabilities of the seller.

It is important to recognize that in a sale of assets the seller retains primary responsibility for satisfying all its liabilities, whether or not assumed by the buyer. Unlike a sale of stock or a statutory combination,

9. For further information regarding possible asset purchaser liabilities for contractually unassumed liabilities, see *infra* Part III.

where the shareholders may only be liable to the buyer through the indemnification provisions of the acquisition agreement, a creditor still can proceed directly against the seller after an asset sale. If the seller is liquidated, its shareholders may remain subject to claims of the seller's creditors under statutory or common law principles, although this might be limited to the proceeds received on liquidation and expire after a period of time. Under state corporate law statutes, a seller's directors may become personally liable to its creditors if the seller distributes the proceeds of a sale of assets to its shareholders without making adequate provision for its liabilities.

In determining what liabilities and business risks are to be assumed by the buyer, the lawyers drafting and negotiating the acquisition agreement need to be sensitive to the reasons why the transaction is being structured as a sale of assets. If the parties view the transaction as the acquisition by the buyer of the entire business of the seller, as in a stock purchase, and the transaction is structured as a sale of assets only for tax or other technical reasons, then it may be appropriate for the buyer to assume most or all liabilities, known and unknown. If instead the transaction is structured as a sale of assets because the seller has liabilities the buyer does not want to assume, then the liabilities to be assumed by the buyer will be correspondingly limited.

A buyer may be concerned about successor liability exposure and not feel secure in relying on the indemnification obligations of the seller and its shareholders to make it whole. Under these circumstances, it might also require that the seller maintain in effect its insurance coverage or seek extended coverage for preclosing occurrences which could support these indemnity obligations for the benefit of the buyer.

F. Dissent and Appraisal Rights

The corporation statutes of each state contain provisions permitting shareholders to dissent from certain corporate actions and to seek a court directed appraisal of their shares under certain circumstances by following specified procedures.¹⁰ The principal purpose of these provisions is to protect the rights of minority shareholders who object to a fundamental corporate action which the majority approves.¹¹ The fundamental corporate actions covered vary from state to state, but generally include mergers and in some states conversions, statutory share

10. See Christian J. Henrick, *Game Theory and Gonsalves: A Recommendation for Reforming Stockholder Appraisal Actions*, 56 BUS. LAW. 697, 697 (2001).

11. *Id.*

exchanges, and sales of all or substantially all of the assets of the corporation.¹²

1. Delaware Law

Delaware courts have considered a variety of remedies available to stockholders who oppose merger transactions. The statutory remedy in Delaware for dissenting stockholders is appraisal pursuant to § 262 of the Delaware General Corporation Law (DGCL).¹³ Under DGCL § 262(b), appraisal rights are only available in mergers and consolidations effected pursuant to enumerated sections of the DGCL.¹⁴ Delaware law does not extend appraisal rights to other fundamental changes that trigger appraisal rights under the laws of other states, including sales of all or substantially all of the assets of the corporation or amendments to the corporation's articles of incorporation.¹⁵ Delaware also does not follow the de facto merger doctrine, under which a transaction structured to achieve the same result as a merger will have the same effect, including the triggering of appraisal rights.¹⁶ Delaware instead follows the doctrine of independent legal significance, by which "a given result may be accomplished by proceeding under one section [of the DGCL] which is not possible, or is even forbidden under another."¹⁷ The Delaware appraisal statute permits a corporation to include a provision in its

12. See Stephen H. Schulman & Alan Schenk, *Shareholders' Voting and Appraisal Rights in Corporate Acquisition Transactions*, 38 BUS. LAW. 1529, 1529-36 (1983).

13. DEL. CODE ANN. tit. 8, § 262 (West 2011); see generally R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* § 9.42-9.47 (3d ed. 1998 & Supp. 2011).

14. DEL. CODE ANN. tit. 8, § 262(b). The enumerated sections are *id.* §§ 251, 252, 254, 257, 258, 263 and 264.

15. Compare *id.* § 262 (2011), with MODEL BUS. CORP. ACT § 13.02(a) (2008) (providing for appraisal rights in these situations).

16. See *Hariton v. Arco Elecs., Inc.*, 182 A.2d 22, 25 (Del. Ch. 1962) (refusing to extend appraisal rights under de facto merger doctrine to sale of assets pursuant to DEL. CODE ANN. tit. 8, § 271, finding that "the subject is one which . . . is within the legislative domain"); cf. *Heilbrunn v. Sun Chem. Corp.*, 150 A.2d 755, 758-59 (Del. 1959) (declining to invoke de facto merger doctrine to grant appraisal rights to purchasing corporation in sale of assets).

17. *Hariton*, 182 A.2d at 25; see *Fed. United Corp. v. Havender*, 11 A.2d 331, 342 (Del. 1940) (holding that preferred stock with accrued dividends that could not be eliminated by charter amendment could be converted into a new security under the merger provision of the Delaware code); see also *Field v. Allyn*, 457 A.2d 1089, 1098 (Del. Ch. 1983) (finding it "well established . . . that different sections of the . . . [DGCL] have independent significance and that it is not a valid basis for challenging an act taken under one section to contend that another method of achieving the same economic end is precluded by another section"), *aff'd*, 467 A.2d 1274 (Del. 1983). For more discussion, see generally C. Stephen Bigler & Blake Rohrbacher, *Form or Substance? The Past, Present, and Future of the Doctrine of Independent Legal Significance*, 63 BUS. LAW. 1 (2007).

certificate of incorporation granting appraisal rights under other circumstances.

DGCL § 262(b)(1) carves out certain exceptions when appraisal rights are not available even in mergers and consolidations that otherwise would qualify for appraisal rights. The principal exception is the so-called “market-out exception,” pursuant to which appraisal rights are not available to any class or series of stock listed on a national securities exchange or held of record by more than two thousand holders.¹⁸

Thus, stated generally, DGCL § 262(b) provides appraisal rights in any merger where the holders of shares receive cash or securities other than stock of a widely held corporation, stock of the surviving corporation, or a mix of the two. Delaware law also provides specifically for appraisal rights in a short-form merger.¹⁹

2. Texas Law

Under the Texas Business Organizations Code (TBOC) and subject to certain limitations, a shareholder of a Texas corporation has the right to dissent from any of the following corporate actions: a merger, a statutory share exchange, or the sale of all or substantially all of the assets of the corporation,²⁰ provided that shareholder approval of the corporate action is required and the shareholder holds shares of a class or series entitled to vote on the corporate action.²¹ The purpose of the

18. DEL. CODE ANN. tit. 8, § 262(b)(1). DGCL § 262(b)(1) also specifies that depository receipts associated with such shares are governed by the same principles as shares for purposes of appraisal rights. In an exception to the market-out exception, DGCL § 262(b)(2) restores appraisal rights to shares otherwise covered by the market-out if the holders of shares are required to accept anything other than: (a) shares of stock of the corporation surviving or resulting from the merger, regardless of whether they are publicly traded or widely held; (b) shares of stock of another corporation that are publicly traded or widely held; (c) cash in lieu of fractional shares; or (d) any combination of shares or fractional shares meeting the requirements of (a), (b) and (c). *Id.* § 262(b)(2). DGCL § 262(b)(1) also provides that no appraisal rights shall be available for any shares of stock of the constituent corporation surviving the merger if the holders of those shares were not required to vote to approve the merger. *Id.* § 262(b)(1). The exceptions set forth in DGCL §§ 262(b)(1) and (b)(2) apply equally to stockholders of the surviving corporation and the acquired corporation and to both voting and non-voting shares. *Id.* § 262(b)(1)-(2).

19. *See id.* §§ 253(d), 262(b)(2).

20. TEX. BUS. ORGS. CODE ANN. § 10.354 (West 2011). TBOC § 21.451(2) defines “sale of all or substantially all of the assets” of the corporation as a transaction not made in the “usual and regular course of . . . business” of the corporation and that a transaction is in “usual and regular course of . . . business” of the corporation if thereafter the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction in the conduct of a business in which it engages following the transaction. *Id.* § 21.451(2).

21. *Id.* § 10.354.

dissenters' rights provisions of the TBOC is to provide shareholders with the opportunity to choose whether to sell their shares at a fair price (as determined by a court) or to be bound by the terms of the corporate action.²²

G. *Income Taxes*

In most acquisitions, the income tax consequences to the buyer and to the seller and its shareholders are among the most important factors in determining the structure of the transaction. The shareholders will prefer a structure that will generate the highest after-tax proceeds to them, while the buyer will want to seek ways to minimize taxes after the acquisition.

In a taxable asset purchase (or a transaction treated as a taxable asset purchase, as discussed below), the buyer's tax basis in the purchased assets will be equal to the purchase price including assumed liabilities. The key tax advantage to the buyer of an asset purchase, assuming the purchase price is greater than the seller's tax basis in the assets, is the ability to "step up" the tax basis of the acquired assets to the purchase price (presumably the fair market value of the assets). This increase in tax basis allows the buyer greater depreciation and amortization deductions in the future and less gain (or greater loss) on a subsequent disposition of those assets. In practice, much of the step up is usually allocable to intangible assets of the seller that have a very low tax basis to the seller, and the buyer is permitted to amortize the resulting tax basis over 15 years. These tax benefits to the buyer can make an asset acquisition (or deemed asset acquisition) much more valuable to a buyer than a stock acquisition.

On the other hand, a sale of assets can result in tax disadvantages to the seller. This is particularly so when the seller is a "C" corporation that is selling its assets and liquidating. In that case, (1) the corporation recognizes gain on the sale of its assets, and (2) the shareholders recognize gain on the liquidation measured by the excess of the cash and property received (which will be reduced by the selling corporation's tax liability) and their tax basis in the corporate stock. Moreover, corporations do not receive the benefit of a lower tax rate on capital gains, and all their gain is taxable at the maximum rate of 35%. This double tax on a corporate liquidation has existed since the repeal in 1986 of the so-called *General Utilities* Doctrine, which had exempted a C corporation from most corporate—level taxation on the sale of its assets followed by a complete liquidation.

22. See generally *Massey v. Farnsworth*, 353 S.W.2d 262, 267-68 (Tex. Civ. App. 1961), *rev'd on other grounds*, 365 S.W.2d 1 (Tex. 1963).

Unless the corporation has net operating losses to shelter the gain at the corporate level, an asset sale will usually be significantly worse for the shareholders of a C corporation than a stock sale, since it results in a double tax rather than the single tax that arises from a stock sale. On the other hand, a buyer purchasing stock of a C corporation will not obtain a stepped-up basis in the assets. (Although it obtains a cost basis in the stock of the target corporation, this basis cannot be amortized or depreciated for tax purposes.) As a result, the buyer generally would be willing to pay less to the shareholders for stock of the corporation than it would pay the corporation itself for its assets. However, the adverse effect of an asset sale to the sellers is generally greater than the benefit of an asset sale to the buyer (because the corporate tax on an asset sale arises upfront while the benefit of an asset sale to the buyer arises only over time). Therefore, the buyer will generally not be willing to pay enough extra to the sellers to offset their increased tax liability from an asset sales. As a result, taxable transactions involving C corporations often are done as stock sales, with the parties often agreeing to reduce the purchase price to reflect the lack of step-up in asset basis to the buyer, but the sellers still coming out ahead on an after-tax basis as compared to an asset sale.

Different considerations apply if the target is a subsidiary corporation in a group of corporations filing a consolidated federal income tax return. Then, assuming the entire group is not liquidating, there is no shareholder level tax at stake, and so there is no double tax issue. Rather, the issue from the seller's point of view is the amount of the single tax. If the subsidiary sells assets or is considered to sell assets, the taxable gain is based on the subsidiary's tax basis for its assets. If the shareholder of the subsidiary sells, or is considered to sell, the stock of the subsidiary, the taxable gain is based on the group's tax basis in that stock. From the buyer's point of view, an asset purchase or deemed asset purchase is again more favorable because of the stepped-up tax basis it will receive in the assets.

If the selling consolidated group has the same tax basis in the stock of the target as the target has in its assets (which is usually the case if the target was originally formed within the group), the total tax to the selling group should be the same for a stock sale or asset sale. In that case, the buyer will generally insist on buying assets, and the seller will have no tax reason to refuse. If the selling group has a higher tax basis in the stock of the target corporation than the target has in its assets (usually the case if the group had previously purchased the stock of the target from a third party), an asset sale will result in more tax cost to the seller than a stock sale. In that case, depending on the difference in tax cost, the parties may or may not be able to agree on an increased purchase price

that will compensate the seller for its extra tax cost and give the buyer the benefit of the step-up in asset basis. If the buyer's potential benefit is less than the extra tax cost to the seller, then a stock sale will obviously occur.

In this situation, if the parties agree that the transaction should be treated as an asset sale for tax purposes, a "real" asset sale with all its procedural complexities is not necessary. Rather, the agreement can provide for a stock sale, and provide that both parties agree to make an election under IRC § 338(h)(10). Then, the transaction is treated for tax purposes as if the target corporation sold all its assets to a new subsidiary of the buyer, and then distributed the sale proceeds in complete liquidation. Since the target is in a consolidated group, the deemed liquidation is tax-free. As a practical matter, therefore, when a consolidated subsidiary is being purchased, the form of the transaction is often a stock sale, and the tax negotiation is over whether or not the seller will agree to an IRC § 338(h)(10) election. It should be noted that if the buyer will only be buying some of the assets of the target corporation, the election even allows the target to distribute the "unwanted" assets to its parent corporation on a tax-free basis. As a result, if the parties agree to the tax results of an asset sale, a stock sale of a consolidated subsidiary is feasible even when some of the target assets will be left behind in the selling group.

If the target is an S corporation, the S corporation is generally not itself taxable, and so there is no "double tax" from an asset sale as there is with a "C" corporation. Rather, the issue is whether the shareholders will be subject to more tax if the S corporation sells assets and liquidates than if the shareholders sell their stock. Since IRC § 338(h)(10) applies to S corporations, as a practical matter the transaction can take the form of a sale of stock of the S corporation, and the issue is whether the parties will elect to treat the stock sale as an asset sale for tax purposes.

Generally, the amount and character of the gain or loss at the S corporation level will pass through to the shareholders, will be taken into account on their individual tax returns, and will increase or decrease their tax basis in the stock. In principle, therefore, the shareholders will have the same total net gain or loss if the corporation sells its assets and liquidates, or if the shareholders sell their stock for the same amount. However, the shareholders will generally have long term capital gain on a stock sale, taxable at favorable rates, while on an asset sale the character of the gain that is passed through to the shareholders is determined by the nature of the S corporation assets. It is possible that some of the corporate level gain would be ordinary income or short term capital gain, which when passed through to the shareholders would put them in a worse position than if they had sold their stock. In an extreme

case, the shareholders might have ordinary income passed through from the S corporation in excess of their total economic gain on its stock, with an offsetting capital loss allowed on the liquidating distribution. As a result, there could still be tax disadvantages to the shareholders of an S corporation from an asset sale as compared to a stock sale. In that case negotiations with the buyer are generally necessary to determine if the buyer will pay a higher price for assets (or an IRC § 338(h)(10) election) as compared to stock.

Finally, if an S corporation was formerly a C corporation, and if it held any assets on the conversion date with “built-in gain,” it must pay tax on that gain at the corporate level if it sells the assets within 10 years of the effective date of the election (or certain shorter statutory periods). This rule could also make an asset sale (or an IRC § 338(h)(10) election) more expensive for the selling shareholders than a stock sale.

The preceding discussion relates to federal income taxes under the Code. Special consideration also must be given to state and local tax consequences of the proposed transaction.

H. Transfer Taxes

Many state and local jurisdictions impose sales, documentary, or similar transfer taxes on the sale of certain categories of assets. For example, a sales tax might apply to the sale of tangible personal property, other than inventory held for resale, or a tax might be required for recording a deed for the transfer of real property. In most cases, these taxes can be avoided if the transaction is structured as a sale of stock or a statutory combination. These taxes might also be avoided if the transaction is in form a stock sale that is treated as an asset sale under IRC § 338(h)(10). That is because an election under that section will generally apply for state income and franchise tax purposes, but not necessarily for state and local nonincome tax purposes. Note also that some states, including New York, now impose a real property transfer tax on the transfer of a controlling stock interest in a corporation that owns real property in the state, whether or not an IRC § 338(h)(10) election is made. Responsibility for payment of transfer taxes is negotiable, but often under state law the seller will remain primarily liable for the tax and the buyer may have successor liability for them. It therefore will be in each party’s interest that these taxes are timely paid.

State or local taxes on real and personal property should also be examined, because there may be a reassessment of the value for tax purposes on transfer. However, this can also occur in a change in control resulting from a sale of stock or a merger.

I. Employment Issues

Employee issues are a significant consideration in any change in control transaction, whatever the form. A sale of assets may yield more employment or labor issues than a stock sale or statutory combination because the seller will typically terminate its employees who may then be employed by the buyer. Both the seller and buyer run the risk that employee dislocations from the transition will result in litigation or, at the least, ill will of those employees affected. The financial liability and risks associated with employee benefit plans, including funding, withdrawal, excise taxes, and penalties, may differ depending on the structure of the transaction. Responsibility under the Worker Adjustment and Retraining Notification Act (WARN Act)²³ can vary between the parties, depending upon whether the transaction is structured as an asset purchase, stock purchase or statutory combination. In a stock purchase or statutory combination, any collective bargaining agreements generally remain in effect. In an asset purchase, the status of collective bargaining agreements will depend upon whether the buyer is a “successor,” based on the continuity of the business and work force or provisions of the seller’s collective bargaining agreement. If it is a successor, the buyer must recognize and bargain with the union.²⁴

J. Confidentiality Agreement

A confidentiality agreement is typically the first stage for the due diligence process as parties generally are reluctant to provide confidential information to the other side without having the protection of a confidentiality agreement. The target typically proposes its form of confidentiality agreement, and a negotiation of confidentiality agreement ensues.

K. Exclusivity Agreement

At an early stage in the negotiations, the buyer may ask for the seller to agree to negotiate exclusively with the buyer.²⁵ The buyer will argue that it will have to spend considerable time and resources in investigating the target and developing a deal proposal, and it wants assurance that the target will not sell to another bidder before a proposal

23. 29 U.S.C. §§ 2101-09 (2006).

24. *Smullin v. MITY Enters.*, 420 F.3d 836, 840-41 (8th Cir. 2005).

25. For the forms of exclusivity agreements, see Appendices C and D, Richard E. Climán et. al., *Negotiating Acquisitions of Public Companies in Transactions Structured as Friendly Tender Offers*, 116 PENN ST. L. REV. 615, app. C at 704, app. D at 708 (2012).

can be developed and negotiated. As with public companies, private companies may agree to negotiate exclusively with a suitor for a relatively short period (usually no more than a few weeks or months) to induce the prospective buyer to commence its due diligence and develop an acquisition proposal.²⁶ In the acquisition of a private company, the exclusivity agreement is sometimes included in a letter of intent as the seller may be reluctant to agree not to negotiate with anyone else until it has confidence the suitor is making an offer good enough to merit negotiation.

L. Letter of Intent

A letter of intent is often entered into between a buyer and a seller following the successful completion of the first phase of negotiations of an acquisition transaction. A letter of intent typically describes the purchase price (or a formula for determining the purchase price) and certain other key economic and procedural terms that form the basis for further negotiations. In most cases, the buyer and the seller do not yet intend to be legally bound to consummate the transaction and expect that the letter of intent will be superseded by a definitive written acquisition agreement. Alternatively, buyers and sellers may prefer a memorandum of understanding or a term sheet to reflect deal terms. Many lawyers prefer to bypass a letter of intent and proceed to the negotiation and execution of a definitive acquisition agreement.

Although the seller and the buyer will generally desire the substantive deal terms outlined in their letter of intent to be nonbinding expressions of their then-current understanding of the shape of the prospective transaction, letters of intent frequently contain some provisions that the parties intend to be binding.

III. SUCCESSOR LIABILITY

A. Background

In any acquisition, regardless of form, one of the most important issues to be resolved is what liabilities incurred prior to the closing by the seller are to be assumed by the buyer. Most of such liabilities will be known, perhaps set forth in the representations and warranties of the seller in the acquisition agreement and in the exhibits thereto, reflected in the seller's financial statements, or otherwise disclosed by the seller to the buyer in the course of the negotiations and due diligence in the

26. See Richard E. Climan et al., *Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 218, 220, 229-31, app. C at 273 (2002).

acquisition. For such known liabilities, the issue as to which will be assumed by the buyer and which will stay with the seller is resolved in the express terms of the acquisition agreement and is likely to be reflected in the price. For unknown liabilities, the solution is not so easy and lawyers representing principals in acquisition transactions spend significant time and effort dealing with the allocation of responsibility and risk in respect of such unknown liabilities.

While all of the foregoing would pertain to an acquisition transaction in any form, the legal presumption as to who bears the risk of undisclosed or unforeseen liabilities differs markedly depending upon which of the three conventional acquisition structures has been chosen by the parties.

- In a stock acquisition transaction, since the acquired corporation simply has new owners of its stock and has not changed in form, the corporation retains all of its liabilities and obligations, known or unknown, to the same extent as it would have been responsible for such liabilities prior to the acquisition. In brief, the acquisition has had no effect whatsoever on the liabilities of the acquired corporation.
- In a merger transaction, where the acquired corporation is merged out of existence, all of its liabilities are assumed, as a matter of state merger law, by the corporation which survives the merger. Unlike the stock acquisition transaction, a new entity will be responsible for the liabilities of the constituent entities. However, the practical result is the same as in a stock transaction (i.e., the buyer will have assumed all of the preclosing liabilities of the acquired corporation as a matter of law).
- By contrast, in an asset purchase, the contract between the parties is expected to determine which of the assets will be acquired by the buyer and which of the liabilities will be assumed by the buyer. Thus, the legal presumption is very different from the stock and merger transactions: the buyer will not assume liabilities of the selling corporation which the buyer has not expressly agreed to assume by contract.

There are a number of business reasons for structuring an acquisition as an asset transaction rather than as a merger or purchase of stock. Some are driven by the obvious necessities of the deal; e.g., if less than all of the assets of the business are being acquired, such as when one acquires a division of a large corporation. However, there is

probably no more important reason for structuring an acquisition as an asset transaction than the desire on the part of the buyer to limit the liabilities by express provisions of a contract—particularly unknown or contingent liabilities which the buyer does not intend to assume.

There have been some recognized exceptions to the buyer's ability to avoid seller's liabilities by the terms of an acquisition agreement between the seller and the buyer. One of the exceptions is the application of various successor liability doctrines that may cause a buyer to be responsible for product, environmental, and certain other liabilities of the seller or its predecessors.²⁷ The remainder of this article will describe the principal theories of successor liability and will address some of the techniques that lawyers have used to deal with those problems.

B. The General Rule of Successor Liability

During the past four decades, the buyer's level of comfort that it will not be responsible for unassumed liabilities has dropped somewhat. During that period, courts have developed some theories which require buyers to be responsible for seller preclosing liabilities in the face of express contractual language in the asset purchase agreement to the contrary. In addition, since the early 1980's, federal and state statutes have imposed strict liability for certain environmental problems on parties not necessarily responsible for causing those problems. These developments, particularly in the areas of product liability, labor and employment obligations, and environmental liability have created problems for parties in asset purchase transactions.

Until about 35 years ago, the general (and well-settled) rule of successor liability was that "where one company sells or transfers all of its assets to another, the second entity does not become liable for the debts and liabilities" of the transferor.²⁸ This rule was derived in the corporate world of contracts between commercial equals, where both parties were knowledgeable and had access to sophisticated advice. Two justifications historically have been given for the rule. First, it "accords with the fundamental principle of justice and fairness, under which the law imposes responsibility for one's own acts and not for the totally independent acts of others."²⁹ The second justification is based on the

27. See generally George W. Kuney, *A Taxonomy and Evaluation of Successor Liability*, 6 FLA. ST. U. BUS. L. REV. 9 (2007).

28. *Polius v. Clark Equip. Co.*, 802 F.2d 75, 77 (3d Cir. 1986) (citing 15 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7122 (perm. ed. 1983)); *Chi. Truck Drivers, Helpers & Warehouse Workers Union Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48, 49 (7th Cir. 1995).

29. *Leannais v. Cincinnati, Inc.*, 565 F.2d 437, 439 (7th Cir. 1977).

bona fide purchaser doctrine, which holds that a purchaser who gives adequate consideration and who has no knowledge of claims against the item purchased, buys the item free of those claims.³⁰

More recently, however, the theory of successor liability has evolved and expanded as the result of a series of clashes between conflicting policies. This is a recurring theme throughout the successor liability cases, as the benefits attendant to a corporation's ability to sell its assets in an unrestricted manner are balanced against other policies, such as the availability of other remedies to the injured party, and who can best bear the cost of protecting persons in the same situation as the plaintiff.

There are nine different theories under which one or more types of a predecessor's liabilities could be imposed upon a successor. These theories are as follows:

1. express or implied agreement to assume;
2. de facto merger (a/k/a consolidation);
3. mere continuation;
4. fraud;
5. continuity of enterprise (a/k/a substantial continuation);
6. product line;
7. duty to warn;
8. inadequate consideration for the transfer, coupled with the failure to make provision for the transferor's creditors; and
9. liability imposed by statute.

The first four exceptions are often referred to as the "traditional" exceptions because they were developed first, whereas the fifth and sixth exceptions, which have developed more recently, are sometimes called the "modern exceptions." The last three exceptions are somewhat more

30. Debra Ann Schiff, Note, *Products Liability and Successor Corporations: Protecting the Product User and the Small Manufacturer Through Increased Availability of Products Liability Insurance*, 13 U.C. DAVIS L. REV. 1000, 1005-06 (1980).

narrow and fact-specific and are therefore less prevalent in the literature than the others.

1. Express or Implied Assumption

The determination as to whether the purchaser expressly assumed the seller's obligations usually involves a fact-specific inquiry, which focuses on the provisions of the purchase agreement (especially the included and excluded asset descriptions, the definition (if any) of the term "assumed liabilities" and the indemnity clause) and the parties' intent.

Similarly, a buyer's implied assumption of a seller's obligations often is determined by the buyer's conduct or representations indicating an intention by the buyer to assume the seller's debts, coupled with reliance by the party asserting liability on that conduct or on those representations.³¹

The other issue which arises regarding the assumption of liabilities relates to whether an unforeseen liability was implicitly assumed. For example, in *Mobay Corp. v. Allied-Signal, Inc.*,³² the court ruled that a purchaser of contaminated property was not foreclosed from bringing environmental claims against a seller of the property under the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended (CERCLA, or Superfund),³³ merely by agreeing to indemnify the seller from all obligations and liabilities arising out of post-closing claims or lawsuits for personal injury or property damage.³⁴ Contrast that case with *Kessinger v. Grefco, Inc.*,³⁵ in which the court held that an asset purchase agreement (in which the buyer assumed and agreed "to pay, perform and discharge all debts, obligations, contracts and liabilities") amounted to the buyer's assumption of the seller's unforeseen product-liability claims.³⁶

2. De Facto Merger

Initially, the *de facto* merger theory was based upon the notion that, while a transaction had been structured as an asset purchase, the result looked very much like a merger. The critical elements of a *de facto* merger were that the selling corporation had dissolved right away and

31. 15 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7124 (perm. ed., rev. vol. 1989).

32. *Mobay Corp. v. Allied-Signal, Inc.*, 761 F. Supp. 345 (D.N.J. 1991).

33. 42 U.S.C. §§ 9601-75 (2006).

34. *Allied-Signal*, 761 F. Supp. at 358.

35. *Kessinger v. Grefco, Inc.*, 875 F.2d 153 (7th Cir. 1989).

36. *Id.* at 154.

that the shareholders of the seller had received stock in the buyer. These two facts made the result look very much like a merger. The theory was applied, for example, to hold that dissenters' rights granted by state merger statutes could not be avoided by structuring the transaction as an asset sale. While this may have pushed an envelope or two, the analysis was nonetheless framed within traditional common law concepts of contract and corporate law. However, the *de facto* merger doctrine was judicially expanded in one state in 1974 to eliminate the requirement that the corporation dissolve.³⁷ More importantly, the expansion introduced into the equation the public policy consideration that, if successor liability were not imposed, a products-liability plaintiff would be left without a remedy.³⁸ In balancing the successor company's interest against such a poor plaintiff, the plaintiff won.³⁹

The elements of a *de facto* merger were set forth in *Phila. Elec. Co. v. Hercules, Inc.*:⁴⁰

1. There is a continuation of the enterprise of the seller corporation, so that there is a continuity of management, personnel, physical location, assets and general business operations.
2. There is a continuity of shareholders which results when the purchasing corporation pays for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation.
3. The seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible.
4. The purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operation of the seller corporation.⁴¹

In 1995 the United States District Court for the Eastern District of Pennsylvania applied the doctrine of *de facto* merger to find successor liability for environmental costs in *SmithKline Beecham Corp. v. Rohm*

37. *Knapp v. N. Am. Rockwell Corp.*, 506 F.2d 361, 370 (3d Cir. 1974).

38. *Id.*

39. *Id.*

40. *Phila. Elec. Co. v. Hercules, Inc.*, 762 F.2d 303, 310 (3d Cir. 1985).

41. *Id.*

& Haas Co.⁴² The District Court indicated that all four elements of a *de facto* merger set forth in *Hercules* did not have to be present (although all four factors were found in this case). In addition, the District Court determined that Pennsylvania law does not require that the seller's former shareholders take control over the buyer in order to satisfy the continuity of a shareholder factor above-mentioned. The United States Court of Appeals for the Third Circuit reversed the District Court and held that the *de facto* merger doctrine would not apply in the circumstances of this case.⁴³ The facts of *SmithKline Beecham* were somewhat unusual. Beecham had bought assets of a company from Rohm and Haas in 1978. Rohm and Haas had given an indemnification to Beecham for all liabilities prior to the closing, and Beecham indemnified Rohm and Haas for liabilities following the 1978 transaction. Rohm and Haas in turn had bought the company in an asset transaction in 1964. The District Court had held that the 1964 transaction satisfied the *de facto* merger rule, which meant that Rohm and Haas would be liable for the prior owner's unknown liabilities and therefore those pre-1964 liabilities would be swept up in the indemnification which Rohm and Haas had given to Beecham fourteen years later. On appeal the Third Circuit determined that Rohm and Haas did not intend in the 1978 indemnification provision to include its liabilities incurred prior to its ownership of Beecham.⁴⁴ Thus, the Third Circuit made the following determinations:

In this case, the parties drafted an indemnification provision that excluded successor liability. SKB and R & H chose to define 'Business' and limit its meaning to New Whitmoyer. Under these circumstances, we believe it was not appropriate for the district court to apply the *de facto* merger doctrine to alter the effect of the indemnification provision. . . . But where two sophisticated corporations drafted an indemnification provision that excluded the liabilities of a predecessor corporation, we will not use the *de facto* merger doctrine to circumvent the parties' objective intent.⁴⁵

The Third Circuit's reasoning suggests that if two parties intend that successor liability shall not occur, the Third Circuit will respect those intentions. If this is so, *SmithKline Beecham* seriously undermines the very basis of the *de facto* merger doctrine: that a court will use the

42. *SmithKline Beecham Corp. v. Rohm & Haas Co.*, No. 92-5394, 1995 WL 117671, at *9-16 (E.D. Pa. Mar. 17, 1995).

43. *SmithKline Beecham Corp. v. Rohm & Haas Corp.*, 89 F.3d 154, 163 (3d Cir. 1996).

44. *Id.*

45. *Id.*

doctrine to impose liability on the successor in spite of the express intentions of the parties in an asset purchase agreement to the contrary.⁴⁶

More recently, the United States Court of Appeals for the Second Circuit in *Cargo Partner AG v. Albatrans, Inc.*,⁴⁷ a case involving a suit over trade debt, ruled that, without determining whether all four factors discussed above need to be present for there to be a *de facto* merger, a corporation that purchases assets will not be liable for a seller's contract debts under New York law absent continuity of ownership which "is the essence of a merger."⁴⁸ The Second Circuit cited a New York case in which the court had stated that not all of the four elements are necessary to find a *de facto* merger.⁴⁹

Some states have endeavored to legislatively repeal the *de facto* merger doctrine. For example, TBOC § 10.254 provides:

Sec. 10.254. DISPOSITION OF PROPERTY NOT A MERGER OR CONVERSION; LIABILITY. (a) A disposition of all or part of the property of a domestic entity, regardless of whether the disposition requires the approval of the entity's owners or members, is not a merger or conversion for any purpose.

(b) Except as otherwise expressly provided by another statute, a person acquiring property described by this section may not be held responsible or liable for a liability or obligation of the transferring domestic entity that is not expressly assumed by the person.

In *C.M. Asfahl Agency v. Tensor, Inc.*,⁵⁰ a Texas Court of Civil Appeals, quoting Article 5.10 of the Texas Business Corporation Act (the statutory predecessor of TBOC § 10.254) and citing two other Texas cases, wrote as follows:

This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation's liabilities unless the successor expressly assumes those liabilities [citations omitted]. . . . Even if the Agency's sales and marketing agreements with the Tensor parties purported to bind their "successors and assigns," therefore, the agreements could not contravene the protections that article 5.10 . . . afforded Allied Signal in acquiring the assets of the Tensor parties unless Allied Signal

46. See H. Lawrence Tafe, *The De Facto Merger Doctrine Comes to Massachusetts Wherein The Exception to the Rule Becomes the Rule*, 42 BOSTON B.J. 12, 24-25 (1998).

47. *Cargo Partner AG v. Albatrans, Inc.*, 352 F.3d 41 (2d Cir. 2003).

48. *Id.* at 47.

49. *Fitzgerald v. Fahnestock & Co.*, 730 N.Y.S.2d 70, 71 (App. Div. 2001).

50. *C.M. Asfahl Agency v. Tensor, Inc.*, 135 S.W.3d 768 (Tex. App. 2004).

expressly agreed to be bound by Tensor parties' agreements with the Agency.⁵¹

3. Mere Continuation

The mere continuation doctrine differs from the de facto merger exception more in form than in substance, and the factors considered by courts throughout the country are very similar. "The primary elements of [mere] 'continuation' include the common identity of the officers, directors, or stockholders in the predecessor and successor corporations, and the existence of only one corporation at the completion of the transfer."⁵² The exception is very limited and relies on the continuity of the corporate identity, and not on the continuation of the business or its operations.⁵³

4. Fraud

The fraud exception arises from the judicial doctrine that transactions entered into to escape liability should not be permitted. This exception covers the "easy" cases, such as where the consideration for the assets was fictitious or inadequate, or where there is demonstrable intent to defraud creditors; but it has also been applied in the more difficult situations where the transfer of assets, while perfectly legitimate, is done (at least in part) to avoid liability. In some cases, there was a question of whether disclosure to the plaintiff overcame the seller's objective of avoiding liability,⁵⁴ while another early case held that nothing short of actual fraud will vitiate a sale of corporate assets.⁵⁵

In addition to the case law, this area is governed by the Uniform Fraudulent Transfer Act (UFTA), which has been enacted in most jurisdictions. The purpose of UFTA is to limit a debtor's ability to transfer assets if doing so puts them out of reach of its creditors at a time when the debtor's financial condition is, or would be, precarious. The UFTA provides that a "transfer" is voidable by a creditor if (i) the

51. *Id.* at 780-81. See Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation—Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249, 287-90 (2001).

52. *Jacobs v. Lakewood Aircraft Serv., Inc.*, 512 F. Supp. 176, 181 (E.D. Pa. 1981) (citations omitted).

53. *Savini v. Kent Mach. Works, Inc.*, 525 F. Supp. 711, 717 (E.D. Pa. 1981) (citing *Leannais v. Cincinnati, Inc.*, 565 F.2d 437, 440 (7th Cir. 1977)).

54. See, e.g., *Raytech Corp. v. White*, 54 F.3d 187, 192-93 (3d Cir. 1995).

55. *Davis v. Hemming*, 127 A. 514, 518 (Conn. 1925).

transfer is made with actual intent to hinder, delay or defraud a creditor⁵⁶ or (ii) the transfer leaves the debtor insolvent or undercapitalized, and it is not made in exchange for reasonably equivalent value.⁵⁷ If a transaction is determined by a court to constitute a fraudulent transfer under UFTA, the court can order any appropriate equitable relief, such as voiding or enjoining the transfer in whole or to the extent necessary to satisfy creditors' claims, attaching the transferred assets or appointing a receiver to take control of the transferred assets.

5. Continuity of Enterprise

As above noted, the *de facto* merger doctrine has generally been limited to instances where there is a substantial identity between stockholders of seller and buyer—a transaction which looks like a merger in which the selling corporation has gone out of existence and its stockholders have received stock of the buyer. In 1976 the Michigan Supreme Court took the *de facto* merger doctrine a step further and eliminated the continuing stockholder requirement.⁵⁸

6. Product-Line Exception

In 1977, California took a slightly different tack in holding a successor liable in a products-liability case. In *Ray v. Alad Corp.*,⁵⁹ the buyer had acquired essentially all of the seller's assets including plant, equipment, inventories, trade name, goodwill, etc. and had also employed all of its factory personnel. The buyer continued to manufacture the same line of products under the seller's name and generally continued the seller's business as before. Successor liability was found by the California Supreme Court as follows:

56. Since intent to hinder, delay, or defraud is usually inferred, a set of factors has been developed to assist in making the determination. *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254 (1st Cir. 1991).

57. *In re WCC Holding Corp.*, 171 B.R. 972, 984-86 (Bankr. N.D. Tex. 1994).

58. In *Turner v. Bituminous Cas. Co.*, 244 N.W.2d 873 (Mich. 1976), the court was dealing with a transaction in which the consideration was cash, rather than stock, and the court concluded that this fact alone should not produce a different result from that which would obtain under a *de facto* merger analysis if the consideration had been stock. Under this "continuity of enterprise" test, successor liability can be imposed upon findings of (1) continuity of the outward appearance of the enterprise, its management personnel, physical plant, assets and general business operations; (2) the prompt dissolution of the predecessor following the transfer of assets; and (3) the assumption of those liabilities and obligations necessary to the uninterrupted continuation of normal business operations. These are essentially the same ingredients which support the *de facto* merger doctrine—but without the necessity of showing continuity of shareholder ownership. *Id.* at 883-84.

59. *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977).

A party which acquires a manufacturing business and continues the output of its line of products under the circumstances here presented assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired.⁶⁰

The rationale for this doctrine had moved a long way from the corporate statutory merger analysis of the *de facto* merger doctrine. The court determined that the plaintiff had no remedy against the original manufacturer by reason of the successor's acquisition of the business and consequent ability of the successor to assume the original manufacturer's risk. The court also determined that the responsibility of the successor to assume the risk for previously manufactured product was essentially the price which the buyer had paid for the seller's goodwill and the buyer's ability to enjoy the fruits of that goodwill.⁶¹

Two years after *Ray*, in *Rawlings v. D. M. Oliver, Inc.*,⁶² the defendant successor corporation purchased the seller's assets and continued its general business, but it ceased the manufacture of the specialized product that caused the plaintiff's injury. The court found the failure to manufacture the identical product did not remove the case from the *Ray* product-line exception, and it imposed liability on the successor. Support for the ruling came from the successor's purchase of an ongoing business which it continued at the same location under the same fictitious name, as well as a broad reading of California's policy in strict liability cases to assign responsibility to the enterprise that received the benefit and is in the best position to spread the cost of the injury among members of society.⁶³ Other cases decided since *Ray* have noted that the application of the product-line exception requires a balancing of the risks shifting principle against the fault principle which underlies all tort law.⁶⁴

One of the factors articulated in *Ray* that has received significant review in subsequent cases is the requirement that the plaintiff's remedies were destroyed by the purchaser's acquisition.⁶⁵ In *Kline v. Johns-Manville*,⁶⁶ the court held that a successor would not be liable when it purchased a product line from a predecessor which continued in business until its bankruptcy years later. Similarly, in *Chaknova v.*

60. *Id.* at 11.

61. *See generally id.*; *Ramirez v. Amsted Indus., Inc.*, 431 A.2d 811 (N.J. 1981).

62. *Rawlings v. D. M. Oliver, Inc.*, 159 Cal. Rptr. 119 (Cal. Ct. App. 1979).

63. *Id.* at 124; *see generally* *Greenman v. Yuba Power Products, Inc.*, 377 P.2d 897 (Cal. 1963).

64. *Hall v. Armstrong Cork, Inc.*, 692 P.2d 787, 791 (Wash. 1984).

65. *See, e.g.*, *Santa Maria v. Owens-Ill., Inc.*, 808 F.2d 848, 859 (1st Cir. 1986); *Nelson v. Tiffany Indus., Inc.*, 778 F.2d 533, 538 (9th Cir. 1985); *Kline v. Johns-Manville*, 745 F.2d 1217, 1220 (9th Cir. 1984).

66. *Kline*, 745 F.2d at 1220.

Wilber-Ellis Co.,⁶⁷ the court held that a successor was not liable under the product-line exception where, among other things, the predecessor continued to exist for fifteen months after the acquisition and the successor had no part in the predecessor's eventual dissolution.⁶⁸ In both of these cases, the essential element of causation was missing, since the successor's purchase did not cause either the predecessor's dissolution or the destruction of the plaintiff's remedy. Not all jurisdictions agree, however.⁶⁹

The product-line exception is not without its critics.⁷⁰ Corporate defense counsel also will be comforted that the product-line exception has several limitations. First, it is available only in cases where strict tort liability for defective products is an available theory of recovery.⁷¹ Second, the State of Washington, which is one of the few states to adopt explicitly the product-line exception, has stated just as clearly that the exception does not apply where there is a sale of less than all of the predecessor's assets, because the purchaser cannot be deemed to have caused the destruction of plaintiff's remedy.⁷² Finally, the product-line exception is clearly a minority rule, having been adopted only in four states and rejected in over 20 states.⁷³

However, under applicable choice of law principles (especially in the area of product liability), the law of a state in which an injury occurs may be found applicable and, thus, the reach of those states which have embraced either the product-line exception or the narrower continuity of

67. *Chaknova v. Wilber-Ellis Co.*, 81 Cal. Rptr. 2d 871 (Cal. Ct. App. 1999).

68. *Id.* at 876-77.

69. See, for example, *Pacius v. Thermtroll Corp.*, 611 A.2d 153, 157 (N.J. Super. Ct. Law Div. 1992), which focused more on the fact of the predecessor's nonviability and on the plaintiff's need to have a remedy than on the reason for the predecessor's cessation of operations.

70. See, e.g., *Mullen v. Alarmguard of Delmarva, Inc.*, No. 90C-11-40-1-CV, 1993 WL 258696, at *5 (Del. Super. Ct. June 16, 1993); *Leannais v. Cincinnati, Inc.*, 565 F.2d 437, 441 (7th Cir. 1977); *Woody v. Combustion Eng'g, Inc.*, 463 F. Supp. 817, 820-22 (E.D. Tenn. 1978).

71. See *Florom v. Elliott Mfg.*, 867 F.2d 570, 578 (10th Cir. 1989); *Welco Indus., Inc. v. Applied Cos.*, 617 N.E.2d 1129, 1133 (Ohio 1993); see generally *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977);

72. *Hall v. Armstrong Cork, Inc.*, 692 P.2d 787, 789-90 (Wash. 1984).

73. Adopted in California, New Jersey, Pennsylvania, and Washington. Rejected in Arizona, Colorado, Florida, Georgia, Iowa, Kansas, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, New York, North Dakota, Ohio, Oklahoma, Texas, Vermont, Virginia, and Wisconsin. See, e.g., *Winsor v. Glasswerks PHX, L.L.C.*, 63 P.3d 1040, 1046-48 (Ariz. Ct. App. 2003) (declining to apply the product-line approach); *Semenetz v. Sherling & Walden, Inc.*, 851 N.E.2d 1170, 1171 (N.Y. 2006) (rejecting the product-line exception); *Griggs v. Capital Mach. Works, Inc.*, 690 S.W.2d 287, 292 (Tex. Ct. App. 1985) (rejecting adoption of product line exception to successor liability); *Ostrowski v. Hydra-Tool Corp.*, 144 Vt. 305, 308, 479 A.2d 126, 127 (1984) (declining to adopt the product-line exception as not consistent with state law).

interest doctrine may extend beyond their respective borders.⁷⁴ The choice of law provision in an asset purchase agreement may not govern the choice of law in a successor liability case, thus compounding the difficulties of predicting both what theory of successor liability might be imposed and what state's laws might be applicable to a successor liability claim under applicable choice of law principles.⁷⁵

7. Duty to Warn

The duty to warn exception is an anomaly among the successor liability exceptions, in that it is an independent duty of the successor, and it is derived from the successor's own actions or omissions—namely, the failure to warn customers about defects in the predecessor's products. There are two elements to this exception. First, the successor must know about the defects in the predecessor's products, either before or after the transaction is completed. Second, there must be some continuing relationship between the successor and the predecessor's customers, such as (but not limited to) the obligation to service machinery manufactured by the predecessor.⁷⁶

8. Inadequate Consideration/Creditors Not Provided For

Although the issue of inadequate consideration usually arises as an element of one or more of the other exceptions (typically fraud or de facto merger), occasionally it is cited as a separate exception where the purchaser has not paid adequate consideration, and the seller would be rendered insolvent and unable to pay its debts.⁷⁷ Since the asset sale is the cause of the seller's problems, many courts will try to find a way to rule in favor of an innocent third person who otherwise may be without a remedy. The various rationales used often sound like the analyses used in some de facto merger cases or those found in the product-line exception cases.

74. See generally *Ruiz v. Blentech Corp.*, 89 F.3d 320 (7th Cir. 1996); *Nelson v. Tiffany Indus.*, 778 F.2d 533 (9th Cir. 1985).

75. See *Berg Chilling Sys., Inc. v. Hull Corp.*, 435 F.3d 455, 466 (3d Cir. 2006) (contractual choice of law provision held inapplicable to successor liability claim, with the majority reasoning that the de facto merger doctrine looks beyond the form of the contract to its substance and that a claimant not a party to the contract should not be bound by its choice of law provision).

76. For examples of cases discussing the "duty to warn" exception, see *Chadwick v. Air Reduction Co.*, 239 F. Supp. 247 (E.D. Ohio 1965); *Shane v. Hobam, Inc.*, 332 F. Supp. 526 (E.D. Pa. 1971); *Gee v. Tenneco, Inc.*, 615 F.2d 857 (9th Cir. 1980); and *Travis v. Harris Corp.*, 565 F.2d 443 (7th Cir. 1977).

77. See, e.g., *W. Tex. Ref. & Dev. Co. v. Comm'r*, 68 F.2d 77, 81 (10th Cir. 1933).

Quite often, the inquiry in inadequate consideration cases focuses on the fact that consideration is paid directly to the seller's shareholders rather than to the seller. If the consideration takes the form of the purchaser's stock, one again finds oneself in the de facto merger or mere continuation analysis.

9. Liability Imposed By Statute or Superseding Law

Some courts have found support for successor liability in the broad purpose language of various statutes, such as CERCLA,⁷⁸ the Federal Insecticide, Fungicide, and Rodenticide Act,⁷⁹ the Employee Retirement Income Security Act of 1974 (ERISA),⁸⁰ and Title VII of the Civil Rights Act of 1964 (Title VII).⁸¹ The two-part analysis often used by the courts in the Superfund cases requires the court first to find that a successor could be liable under the provisions of the statute, and then to apply one or more of the exceptions described above to determine whether the corporation in question is, in fact, a successor upon which liability could be imposed.

Besides federal statutes, state laws also may be used to impose liability on a successor. Many states have enacted statutes that largely parallel federal counterparts, especially with respect to environmental obligations. In addition, state tax statutes often impose liability on a successor for certain types of unpaid taxes of the seller, although the types of asset sales that are covered, the types of taxes, and the notice and clearance procedures that allow the buyer to eliminate its potential liability differ from state to state. The buyer must determine which states' laws apply, keeping in mind that more than one state's laws may be applicable. State laws often apply to assets located in that state, regardless of the jurisdiction selected by the parties in their choice of law provision. The validity of such statutes generally has been upheld against attacks on a variety of grounds, including allegations that the statutes violated the due process or equal protection clauses of the Constitution or that they unconstitutionally impaired the asset purchase agreement.⁸²

78. 42 U.S.C. §§ 9601-75 (2006).

79. 7 U.S.C. §§ 136-136y (2006); *see, e.g.*, *Oner II, Inc. v. EPA*, 597 F.2d 184 (9th Cir. 1979) (the first reported environmental case to impose successor liability).

80. Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of U.S.C. 26 and 29). *See, e.g.*, *Upholsterers' Int'l Union Pension Fund v. Artistic Furniture*, 920 F.2d 1323 (7th Cir. 1990).

81. 42 U.S.C. §§ 2000e-2000e-17 (2006). *See, e.g.*, *EEOC v. MacMillan Bloedel Containers, Inc.*, 503 F.2d 1086 (6th Cir. 1974).

82. *See, e.g.*, *People ex rel. Salisbury Axle Co. v. Lynch*, 181 N.E. 460, 462-63 (N.Y. 1932); *Knudsen Dairy Prods. Co. v. State Bd. of Equalization*, 90 Cal. Rptr. 533, 540-41 (Cal. Ct. App. 1970); *Pierce-Arrow Motor Corp. v. Mealey*, 59 N.Y.S.2d 568,

a. Environmental Statutes

In 1980 the federal Superfund law—Comprehensive Environmental Response, Compensation, and Liability Act of 1980—was enacted. In the years since the enactment of that statute, environmental issues have become a central—and often dominant—feature of acquisitions. Moreover, in creating liability of a current owner for the costs of cleaning up contamination caused by a prior owner, the statute effectively preempted the ability of a buyer to refuse to accept liability for the sins of the seller or seller's predecessor. Unlike the theories discussed above which might impose successor liability on a buyer if certain facts appeal to certain courts, CERCLA provides that every buyer will be liable for certain environmental liabilities regardless of the provisions of any acquisition agreement or any common law doctrines or state statutes.

In addition to CERCLA, a number of states have enacted Superfund-type statutes with provisions similar to those of CERCLA. Further, as indicated above, the *de facto* merger and continuity of enterprise doctrines have been applied in environmental cases in states where courts have adopted one or more variations of those themes.

Legislative and judicial changes to how environmental liability may be imposed can affect the potential benefits of an asset purchase. In 2002 Congress passed the Small Business Liability Relief and Brownfields Revitalization Act,⁸³ which created a number of notable exemptions to the otherwise harsh treatment of current owners and operators. A party may now acquire a piece of property, with knowledge of its contamination by hazardous substances, and be exempt from CERCLA liability as a “bona fide prospective purchaser” (BFPP). To qualify as a BFPP, a party must comply with the following requirements:

1. be liable solely due to being the current owner or operator;⁸⁴

571 (App. Div. 1946); *Tri-Fin. Corp. v. Dep't of Revenue*, 495 P.2d 690, 693 (Wash. Ct. App. 1972).

83. Pub. L. No. 107-118, 115 Stat. 2356 (2002).

84. It is unclear whether a tenant under a traditional lease may claim to be a BFPP. CERCLA defines a BFPP to include “a person (*or a tenant of a person*) that acquires ownership of a facility. . . .” 42 U.S.C. § 9601(40) (emphasis added). The term BFPP itself indicates it is meant to apply to one who *purchases* a property; however, there does not appear to be a sound basis not to apply it to a current tenant who could otherwise be deemed a liable “operator.” An EPA guidance document indicates that EPA will not seek enforcement against a tenant with “indicia of ownership” or “a tenant of an owner who is a BFPP.” Memorandum, EPA, Enforcement Discretion Guidance Regarding the Applicability of the Bona Fide Prospective Purchaser Definition in CERCLA § 101(40) to Tenants (Jan. 14, 2009), available at <http://www.epa.gov/compliance/resources/policies/cleanup/superfund/bfpp-tenant-mem.pdf>. This EPA guidance suggests that the only way for a current tenant under a traditional lease to claim BFPP status is to largely

2. acquire the property after January 11, 2002;
3. establish that all disposal of hazardous substances took place prior to acquisition of the asset;
4. prior to acquisition, make “all appropriate inquiries” into the property and its condition; and
5. not be affiliated with a party responsible for any contamination.⁸⁵

In addition, to maintain BFPP status, a landowner must comply with a number of “continuing obligations” as follow:

1. provide all legally required notices with respect to the discovery of any release;
2. exercise appropriate care with respect to the hazardous substances by taking reasonable steps to stop or prevent continued releases and exposures;
3. provide full cooperation, assistance, and access for response actions;
4. comply with and not impede any applicable land use restrictions; and
5. comply with information requests and subpoenas.⁸⁶

A party also may be exempt from CERCLA liability if it is either a new “innocent” owner or operator or a new “contiguous property” owner or operator. Both of these exemptions require that “all appropriate inquiries” into the property and its environmental condition be performed prior to acquisition and that no hazardous substance contamination be found.⁸⁷ After post-acquisition discovery of any contamination, these

rely upon the BFPP status of a landlord, who may have acquired the property prior to 2002 and the CERCLA amendments and over whom a tenant will have no control. Nevertheless, this issue appears to remain unresolved, and effort should be made to preserve a BFPP argument if possible.

85. 42 U.S.C. §§ 9601(40)(A)-(B), (H) and 9607(r) (2006).

86. *Id.* § 9601(40)(C)-(G) (2006).

87. *Id.* §§ 9607(b)(3), 9601(35), 9607(q) (2006).

exemptions also require conduct very similar to the “continuing obligations” outlined above for a BFPP to avoid CERCLA liability.⁸⁸

A final consideration for an asset purchaser is a United States Supreme Court decision that discounts the historic joint and several application of CERCLA if a party such as a new asset owner can claim that its liability is “divisible” from that of other liable parties. The Court in *Burlington N. & Santa Fe Ry. Co. v. United States*⁸⁹ held that “apportionment is proper when ‘there is a reasonable basis for determining the contribution of each cause to a single harm.’”⁹⁰ In the *Burlington* case, BNSF was held liable for only 9% of site contamination costs using the following factors: (1) the percentage of the site owned by it; (2) the percentage of the time upon which its contaminating activities occurred; and (3) the relative hazard of the contaminating chemical at issue.⁹¹ A new owner of a piece of property could fare well under such a methodology, particularly if its liability is solely attributable to being the current “owner” with no involvement in historic contamination.

b. Federal Common Law/ERISA

In *Brend v. Sames Corp.*,⁹² an asset purchase agreement expressly provided that the buyer was not assuming any liability under seller’s “top hat” plan, an unfunded deferred compensation plan for selected executives of seller. Following federal common law rather than state law, the Court held that the buyer could be liable if (1) it knew of the claim (which was evidenced by the express non-assumption wording in the asset purchase agreement) and (2) there was substantial continuity of the business.⁹³

The *Brend* buyer and seller were public corporations that continued to exist after the transaction, which involved the sale of a division of seller. No stock of buyer was issued to seller or its shareholders in the transaction, and no employee of seller became an officer or director of buyer. Seller ultimately commenced Chapter 7 bankruptcy proceedings. The former executives of seller sued on a successor liability theory seeking a judicial declaration that buyer was liable under the “top hat” contracts.

Although the “top hat” plan was exempt from most of the provisions of ERISA, the former executives sought to enforce their rights

88. *Id.* §§ 9601(35), 9607(q) (2006).

89. *Burlington N. & Santa Fe Ry. Co.*, 556 U.S. 599 (2009).

90. *Id.* at 1881.

91. *Id.* at 1882-83.

92. *Brend v. Sames Corp.*, No. 00 C 4677, 2002 WL 1488877 (N.D. Ill. July 11, 2002).

93. *Id.* at *3.

under ERISA because, under Illinois common law, “[t]he well-settled general rule is that a corporation that purchases the assets of another corporation is not liable for the debts or liabilities of the transferor corporation,” subject to certain traditional exceptions.⁹⁴ The Court noted that “[s]uccessor liability under federal common law is broader . . . [and] allows lawsuits against even a genuinely distinct purchaser of a business if (1) the successor had notice of the claim before the acquisition; and (2) there was ‘substantial continuity’ in the operation of the business before and after the sale.”⁹⁵ In so holding, the Court followed decisions applying the federal common law of successor liability to multi-employer plan contribution actions.⁹⁶ The opinion was rendered on cross motions for summary judgment by the former executives and the buyer. In denying both motions, the Court wrote as follows:

The evidence submitted precludes summary judgment *against* either party, but is insufficient to enter summary judgment *for* either party. It is undisputed that ITW [buyer] acquired “substantial assets” of Sames [seller]. But the evidence submitted by the parties does not tell us enough about what actually happened after the Purchase Agreement was executed to permit us to fully analyze whether ITW continued the operations of the Binks Business [the acquired division] “without interruption or substantial change.” We know that the Purchase Agreement provided for ITW’s hiring of former Sames employees, but we do not know how many or what percentage of former Sames employees became employees of ITW or whether these employees performed the same jobs, in the same working conditions, for the same supervisors. There is no evidence regarding the production processes or facilities, or whether ITW made the same products or sold to the same body of customers. Additional (absent) relevant evidence would address whether there was a stock transfer involving a type of stock other than common stock, and the exact makeup of the companies’ officers and directors before and after the sale.⁹⁷

c. Effect of Bankruptcy Court Orders

In *MPI Acquisition, LLC v. Northcutt*,⁹⁸ the Alabama Supreme Court held that federal bankruptcy law preempts state law successor liability theories. The court prevented a plaintiff from bringing a

94. *Id.* (quoting *Vernon v. Schuster*, 688 N.E.2d 1172, 1175 (Ill. 1997)).

95. *Id.* (quoting *Chi. Truck Drivers, Helpers & Warehouse Union Pension Fund v. Tasemkin, Inc.*, 59 F.3d 48, 49 (7th Cir. 1995)).

96. *See Upholsterers’ Int’l Union Pension Fund v. Artistic Furniture*, 920 F.2d 1323, 1326-27 (7th Cir. 1990); *Moriarty v. Svec*, 164 F.3d 323, 329 (7th Cir.1998).

97. *Brend*, 2002 WL 1488877, at *7 (emphasis in original).

98. *MPI Acquisition, L.L.C. v. Northcutt*, 14 So. 3d 126 (Ala. 2009).

successor liability suit against a purchaser of assets pursuant to a bankruptcy court order declaring the assets free and clear of liabilities. The opinion references the conflict in both federal and state courts over the issue of whether federal bankruptcy law preempts state successor liability law⁹⁹ and resolves in favor of preemption as follows: “Third parties cannot access ‘worth’ if the bankruptcy court orders that they take the assets free and clear of any and all claims whatsoever, but nonetheless, unsecured creditors can ‘lie in the weeds’ and wait until the Bankruptcy Court approves a sale before it sues [sic] the purchasers.”¹⁰⁰

The *MPI Acquisition* decision is a reminder that bankruptcy court orders do not in all cases preclude successor liability claims under state law, and that the language in the bankruptcy court order can be critical in insulating the buyer against such claims.¹⁰¹

In *Mickowski v. Visi-Track Worldwide, LLC*,¹⁰² the plaintiff obtained a patent infringement judgment against a corporation which subsequently sought protection under the Bankruptcy Code and sold substantially all of its remaining assets with Bankruptcy Court approval.¹⁰³ The Bankruptcy Court later revoked its discharge of debtor liabilities without overturning the asset sale. The plaintiff then sued the asset purchaser, which had not assumed the patent infringement judgment, on the grounds that the purchaser was the successor to and a mere continuation of the bankrupt corporation, arguing that each of the officers and key employees became employees of the asset purchaser performing substantially the same duties and the website of the acquired business indicated it was the same company at a new location.¹⁰⁴ Plaintiff argued that the federal “substantial continuity” test applied in age discrimination cases was applicable and was satisfied by continuation of these personnel.¹⁰⁵ The Sixth Circuit held that the Ohio common law standard for successor liability was applicable to patent infringement cases and that under the Ohio standard for successor liability “‘the basis of this [mere continuation] theory is the continuation of the corporate entity, not the business operation, after the transaction,’

99. *MPI Acquisition*, 14 So. 3d at 128-29.

100. *Myers v. United States*, 297 B.R. 774, 784 (S.D. Cal. 2003) (quoted in *MPI Acquisition*, 14 So. 3d at 129).

101. M&A Jurisprudence Subcommittee, ABA Mergers and Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 65 BUS. LAW. 493, 506-07 (2010).

102. *Mickowski v. Visi-Trak Worldwide, LLC*, 415 F.3d 501 (6th Cir. 2005).

103. *Id.* at 510.

104. *Id.* at 506.

105. *Id.* at 509.

such as when one corporation sells its assets to another corporation with the same people owning both corporations.”¹⁰⁶

C. *Some Suggested Responses*

1. Analysis of Transaction

The first step in determining whether a proposed asset purchase will involve any substantial risk of successor liability is to analyze the facts involved in the particular transaction in light of the developments of the various theories of successor liability above discussed. It is clear that product liability and environmental liability pose the most serious threats as virtually all of the significant developments in the law of successor liability seem to involve either product liabilities or environmental liabilities.¹⁰⁷

a. Product Liability

As products-liability law has evolved since the early 1960s, the courts increasingly have determined that injured consumers who otherwise lack a remedy should be able to recover against successors. More than one court found itself swayed by the plaintiff's inability to bring suit against either a dissolved corporation or its scattered former shareholders.¹⁰⁸

In *Knapp v. N. Am. Rockwell Corp.*,¹⁰⁹ in addition to the de facto merger exception, the court referenced policies underlying the need for the law of products liability.¹¹⁰ In *Turner v. Bituminous Cas. Co.*,¹¹¹ in which the Michigan Supreme Court created the continuity of enterprise exception, the court noted that the plaintiff's injury and loss would be identical regardless of whether the sale of assets was for cash or stock, and therefore disregarded the issue entirely as being irrelevant to the analysis. Noting that “this is a products liability case first and foremost,”¹¹² the court determined that justice would not be promoted if a successor was liable in a merger or a de facto merger, but not in a sale of

106. *Id.* at 510 (citing *Welco Indus., Inc. v. Applied Cos.*, 617 N.E.2d 1129 (Ohio 1993)).

107. *See supra* Part III.B.

108. Stephen H. Schulman, *Commentary: Successor Corporation Liability and the Inadequacy of the Product Line Continuity Approach*, 31 WAYNE L. REV. 135, 139 (1984).

109. *Knapp v. N. Am. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974).

110. *Id.* at 372-73.

111. *Turner v. Bituminous Cas. Co.*, 244 N.W.2d 873 (Mich. 1976).

112. *Id.* at 877.

assets for cash, when the needs and objectives of the parties are the same in all three instances.¹¹³

The use of public policy to find a remedy for a products-liability plaintiff where none traditionally existed reached its height in *Ray* and its product-line exception progeny.¹¹⁴ After determining that the four traditional exceptions did not provide grounds for the plaintiff to recover, the court decided that a "special departure from [the general rule governing succession to liabilities]" was called for by the policies underlying strict tort liability for defective products.¹¹⁵

Finally, as a harbinger of things yet to come, in *Maloney v. Am. Pharm. Co.*,¹¹⁶ the plaintiffs contended that the *Ray* court did not intend that the product-line exception should apply only to strict liability, but rather to all forms of tort liability involving negligence, on the basis of the policy considerations discussed therein.¹¹⁷ The court declined to do so for procedural reasons, but indicated that plaintiffs' policy arguments might be sound.¹¹⁸

b. Environmental Cases

A similar pattern can be discerned in the environmental cases. Where the early cases found little or no liability on the successor, unless the underlying facts were particularly egregious, the later cases broadened the successor's exposure by eliminating some of the requirements needed to hold an asset purchaser liable for seller's environmental liabilities.

While observing that the provisions of CERCLA do not explicitly require that the successor be liable, the court in *Smith Land & Improvement Corp. v. Celotex Corp.*¹¹⁹ compared the benefits derived by the predecessor and successor corporations from having used a pollutant and from failing to use non-hazardous disposal methods with the indirect benefits which accrued to the general public, and concluded that having the successor bear the costs of remediation was consistent with both Congressional intent and the purpose of the statute.¹²⁰ Since the *Smith Land* decision in 1988, a number of other courts, as well as the

113. *Id.* at 883.

114. See *supra* notes 60-70 and accompanying text.

115. *Ray v. Alad Corp.*, 560 P.2d 3, 8-9 (Cal. 1977).

116. *Maloney v. Am. Pharm. Co.*, 255 Cal. Rptr. 1, 2 (Cal. Ct. App. 1988).

117. *Id.* at 4.

118. *Id.* at 4-5.

119. *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86, 92 (3d Cir. 1988) (noting that "Congressional intent supports the conclusion that, when choosing between the taxpayers or a successor corporation, the successor should bear the cost").

120. *Id.* at 91-92.

Environmental Protection Agency and the Department of Justice, have adopted its policy rationale.¹²¹

Courts have proven quite willing to extend the outer reaches of successor liability in asset purchases that include particularly unsympathetic buyers. These cases typically recite the four "traditional" exceptions to the general rule that an asset purchaser is not liable as a successor of the seller: (1) express or implied assumption; (2) de facto merger; (3) mere continuation; and (4) fraud.¹²² Successor liability does also tend to be more liberally applied when an asset purchaser has substantial ties to the seller and even the contamination at issue. For example, in *United States v. Mexico Feed & Seed Co.*, the court acknowledged that the four "traditional" exceptions did not apply.¹²³ The court then applied a very broad interpretation of the "substantial continuity" test in stating that

in the CERCLA context, the imposition of successor liability under the "substantial continuation" test is justified by a showing that in substance, if not in form, the successor is a responsible party. The cases imposing "substantial continuation" successorship have correctly focused on preventing those responsible for the wastes from evading liability through the structure of subsequent transactions.¹²⁴

Several courts that have interpreted the "substantial continuation" test have demonstrated greater willingness to use it against an asset purchaser if that party has knowledge prior to the transaction of the environmental issue from which it is subsequently attempting to distance itself.¹²⁵

121. See, e.g., *United States v. Gen. Battery Corp.*, 423 F.3d 294, 298-99 (3d Cir. 2005); *In re Acushnet River & New Bedford Harbor*, 712 F. Supp. 1010, 1013 (D. Mass. 1989); *United States v. Crown Roll Leaf, Inc.*, 29 ERC 2018, 1988 U.S. Dist. LEXIS 15785, at *21-24 (D.N.J. Oct. 21, 1988); *United States v. Bliss*, Nos. 84-2086C(1), 87-1558C(1), 84-1148C(1), 84-2092C(1), 1988 U.S. Dist. LEXIS 10683, at *21-23 (E.D. Mo. Sept. 27, 1988). As to EPA, see EPA, LIABILITY OF CORPORATE SHAREHOLDERS AND SUCCESSOR CORPORATIONS FOR ABANDONED SITES UNDER THE COMPREHENSIVE ENVIRONMENTAL RESPONSE COMPENSATION AND LIABILITY ACT (1984). As to DOJ, see Joint Motion of Plaintiffs for Summary Judgment on Fraudulent Conveyance and Successor Corporation Claims, *Kelley v. Thomas Solvent Co.*, 725 F. Supp. 1446 (W. D. Mich. 1988) (Nos. K86-164, K86-167); and Memorandum of Points and Authorities of the United States in Operation to Motion of Chemical & Pigment Company for Partial Summary Judgment and in Support of Cross-Motion of United States for Partial Summary Judgment, *United States v. Allied Chem. Corp.*, Nos. 83-5896-FMS, 83-5898-FMS (N.D. Cal. 1990).

122. See, e.g., *United States v. Mexico Feed & Seed Co.*, 980 F.2d 478, 487 (8th Cir. 1992); *United States v. Carolina Transformer Co.*, 978 F.2d 832, 838 (4th Cir. 1992); *La. Pac. Corp. v. Asarco, Inc.*, 909 F.2d 1260, 1263 (9th Cir. 1990).

123. *Mexico Feed*, 980 F.2d at 478.

124. *Id.* at 488.

125. See, e.g., *id.* at 489-90; *Asarco, Inc.*, 909 F.2d at 1265-66.

This analysis has continued to be expanded, culminating in two rather extreme decisions. In *Kleen Laundry & Dry Cleaning Servs., Inc. v. Total Waste Mgmt., Inc.*,¹²⁶ the asset purchaser was held liable, under the continuity of enterprise exception, for leaks in underground storage tanks which had been leased by the seller for six weeks some four years before the transaction.¹²⁷ The ruling was influenced by the purchaser's intention to buy the seller's business, as well as by purchaser's continued servicing of the seller's customers after the sale.¹²⁸ In *United States v. Keystone Sanitation Co.*,¹²⁹ the successor was held liable for a landfill site which had been specifically excluded from the assets conveyed because the purchaser used its shares as consideration (thus making the case look more like a de facto merger or mere continuation case), the agreement stated that the "business" was being bought, the purchaser assumed the seller's service obligation to its customers, the purchaser agreed to help with the collection of the pre-closing receivables, and the seller and its shareholders agreed to enter into noncompetition and consulting agreements with the purchaser.¹³⁰

c. Applicable Laws

In addition to analyzing the particular facts which might give rise to successor liability for either products or environmental concerns, one should obviously also review the laws which might be applicable if a successor liability issue were to arise. While choice-of-law problems may deny 100% comfort, it is a fact that the more expansive doctrines of successor liability above mentioned have been adopted by a relatively small number of states and it may well be that in any particular transaction one can determine that the risk of such doctrines applying in the aftermath of a particular acquisition transaction is very low.

2. Structure of Transaction

If a transaction is likely to be subject to one or more of the doctrines of successor liability, it might be possible to structure the asset purchase in the manner which avoids one or more of the factors upon which courts rely in finding successor liability. In all likelihood the business considerations will dictate most of the essential elements of how the

126. *Kleen Laundry & Dry Cleaning Servs., Inc. v. Total Waste Mgmt., Inc.*, 867 F. Supp. 1136 (D.N.H. 1994).

127. *Id.* at 1139.

128. *Id.* at 1142.

129. *United States v. Keystone Sanitation Co.*, No. 1:CV-93-1482, 1996 WL 672891 (M.D. Pa. Aug. 22, 1996).

130. *Id.* at *5-7.

transaction will be put together—and in particular how the business will be run by the buyer in the future. However, since continuity of the seller's business into the buyer's period of ownership is a common theme in all of the current successor liability doctrines, it may be possible for the buyer to take steps to eliminate some of the elements upon which a successor liability case could be founded. Thus continuity of management, personnel, physical location, trade names, and the like are matters over which the buyer has some control after the asset purchase and might be managed in a way to reduce the risk of successor liability in a close case.

3. Asset Purchase Agreement Provisions

a. Liabilities Excluded

If the buyer is to have any hope of avoiding unexpected liabilities in an asset transaction, the contract between the buyer and the seller must be unambiguous as to what liabilities the buyer is and is not assuming. In any transaction in which a buyer is acquiring an ongoing business, the buyer is likely to be assuming certain of the seller's liabilities, especially obligations incurred by seller in the ordinary course of seller's business. Indeed, it is likely to be very important to the buyer in dealing with the seller's creditors, vendors, customers, etc. that the asset purchase be viewed in a seamless process in which the buyer hopes to get the benefit of seller's goodwill for which the buyer has paid. Under these circumstances however, it is most important that the contract be very clear as to which liabilities the buyer is expressly not assuming.¹³¹

b. Indemnification

As a practical matter, probably the most effective protection of a buyer against successor liability is comprehensive indemnification by the seller, particularly if indemnification is backstopped by a portion of the purchase price held in escrow.¹³²

4. Selling Corporation—Survival

The dissolution of the selling corporation is a factor which the courts have consistently taken into account in successor liability cases. While it may be placing form over substance, if the seller's dissolution were delayed, one of the elements of the successor liability rationale would at least be in doubt.

131. See MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY § 2.4 (2001).

132. See *id.* § 11.

5. Limitation on Assets

In creating a corporate structure for the asset purchase, the buyer should keep in mind the desirability of limiting the assets of the acquired enterprise which might be accessible to a plaintiff in a future successor liability case. Thus, if in the last analysis the buyer is to be charged with a liability created by the seller or a predecessor of the seller, it would be helpful to the buyer if assets available to satisfy that claim were limited in some manner. There may be no way as a practical matter to achieve this result in a manner consistent with the business objectives of the buyer. However, if, for example, the particular line of business with serious product liability concerns were acquired by a separate corporation and thereafter operated consistent with principles which would prevent veil-piercing, at least the buyer would have succeeded in placing a reasonable cap on the successor liability exposure.
